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**BEFORE THE ARIZONA CORPORATION COMMISSION**

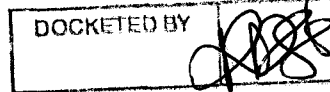
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Arizona Corporation Commission

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SEP 27 2011



**IN THE MATTER OF ORANGE  
GROVE WATER COMPANY, INC.'S  
APPLICATIONS FOR A PERMANENT  
RATE INCREASE AND A FINANCING  
APPROVAL.**

Docket Nos. W-02237A-11-0180  
W-02237A-11-0084

**COMPANY COMMENTS RE  
STAFF'S RESPONSE**

Orange Grove Water Company, Inc. ("Company") hereby files its comments  
regarding Staff's response to Company's comments, which are set forth in Attachment 1.

RESPECTFULLY SUBMITTED this 27<sup>th</sup> day of September, 2011.

**MOYES SELLERS & HENDRICKS LTD.**

Steve Wene  
Attorneys for Company

1  
2 Original and 13 copies filed this  
3 27<sup>th</sup> day of August, 2011, with:

4 Docket Control  
5 Arizona Corporation Commission  
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# **ATTACHMENT 1**

**ARIZONA CORPORATION COMMISSION  
COMPANY RESPONSE TO STAFF'S RESPONSES TO ORANGE GROVE  
WATER COMPANY'S EXCEPTIONS**

**DOCKET NOS. W-02237A-11-0180 AND W-02237A-11-0084**

**PLANT ADDITIONS AND RETIREMENTS DOCUMENTATION**

1. Company Statement: "The Company disputes the claim that the Company has not maintained documentation supporting its plant additions since the last rate case ..."

Staff Response: Staff did not make the claim that "the Company has not maintained documentation supporting its plant additions since the last rate case." Staff found during the audit that the Company had not maintained documentation supporting the actual cost of a pump placed in service approximately six years ago. As a result of the lack of supporting documentation, the Company had to estimate the cost of the pump when the pump was retired.

**Company Response:**

**First, Staff's response is untrue. On Staff Report page 4, ¶ 9, Staff expressly stated "the Company has not consistently maintained adequate supporting documentation for plant additions." Second, the Company notes that estimating the cost of retirements is a common practice and are allowed under the NARUC standards. See page 4 of Staff report.**

2. Company Statement: "The underlying reason for the negative accumulated depreciation for pumping equipment has turned negative is NOT the result of the use of a reverse trend analysis ...."

Staff Response: Staff recalculated the net plant balance for pumping equipment as shown on the attached Staff Response Schedule CSB-1. Staff found that the accumulated depreciation became negative in 1994 when an estimated \$4,653 in pumping equipment was retired.

**Company Response:**

**It is not surprising the accumulated depreciation went negative at various years and is negative today. Pumping equipment was being depreciated using a 20 year life rate through May 2009 while the actual life was far less than 20 years. In other words, the equipment was not fully depreciated at the time of**

**replacement. The depreciation rate utilized did not reflect the actual life of the underlying equipment.**

3. Company Statement: "Orange Grove's pumping equipment has typically been replaced every 4-6 years."

**Staff Response:**

Staff reviewed the pumping equipment additions and retirements reported by the Company for the years 1982 to 2010 in the application for its last rate case (Docket No. W-02237A-08-0455). As shown on Staff Response Schedule CSB-1, Staff found that:

- a. Beginning from 1982, the first replacement occurred 13 years later in 1994.
- b. Beginning from 1994, the next replacement occurred nine years later in 2003.
- c. Beginning from 2003, the next replacement occurred four years later in 2007.
- d. Beginning from 2007, the next replacement occurred three years later in 2010.

Therefore, Staff does not agree that the pumping equipment has typically been replaced every four to six years.

**Company Response:**

**Staff's factual allegations are incorrect causing Staff's analysis to be flawed. On average, the pumping equipment has been replaced approximately 5.6 years as shown below:**

1. Starting in 1982, the first replacement occurred 7 years later in 1989.
2. The next replacement occurred 5 years later in 1994.
3. The next replacement occurred 9 years later in 2003.
4. The next replacement occurred 4 years later in 2007.
5. The next replacement occurred 3 years later in 2010.

**Thus, pumping equipment is replaced every 5.6 years on average (average of 7,5,9,4, and 3 years, respectively).**

4. Company Statement: "The solution to correcting the negative accumulated depreciation situation for pumping equipment is to increase the depreciation rate to a rate that is more reflective of the Company's actual experience with respect to pumping equipment; perhaps on the order of 16.7% (6 year life) rather than the 12.5% employed in the instant case."

Staff Response: Staff does not agree that the depreciation rate for pumping equipment should be changed from the 12.5 percent approved by the Commission unless the Company provides a depreciation study.

**Company Response:**

**The incontrovertible facts demonstrate that pumping equipment is replaced on average every 5.6 years. Accordingly, the appropriate depreciation rate is 17.85%. There is no need to perform a "study" when the objective facts supporting a depreciation rate are before the Commission.**

**Further, it is incontrovertible that the Company was required to use a 20 year life (or 5% depreciation rate) for equipment that lasted on average 5.6 years. Based upon this depreciation rate, the Company recovered on average about 28% of the cost through depreciation.**

**NARUC requires that the book cost be credited to accumulated depreciation. See NARUC Accounting Instruction No. 27 B (2). When assets are not fully depreciated, as in the instant case, accumulated depreciation will go negative. This treatment allows for eventual recovery of all investment necessary to serve customers. This is the underlying rationale for the NARUC accounting instruction.**

5. Company Statement: "Such treatment is unwarranted and would deprive the Company of the full recovery of its investment." The Company is commenting on Staff's recommendation concerning estimates for pump retirements.<sup>1</sup>

Staff Response: Staff does not agree that the treatment is unwarranted and would deprive the Company of the full recovery of its investment. An estimate is only used when the Company does not know the actual cost of the pump. Therefore, since the actual cost is not known, the Company does not know whether Staff's treatment would result in depriving the Company of its full investment.

**Company Response:**

**NARUC requires that the book cost be credited to accumulated depreciation. NARUC Accounting Instruction No. 27 B (2) states:**

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<sup>1</sup> Staff recommends that, on a going-forward basis, if an estimate of the actual cost of a plant asset exceeds the accumulated depreciation balance for that plant account, the estimated cost be adjusted so that it does not exceed the balance of the accumulated depreciation for that plant account

**When a retirement unit is retired from utility plant, with or without replacement, the book cost thereof shall be credited to the utility plant account in which it is included, determined in a manner set forth in paragraph D, below. *If the retirement unit is of a depreciable class, the book cost of the unit retired and credited to the utility plant account shall be charged to the accumulated depreciation applicable to such property.... (emphasis added)***

**When assets are not fully depreciated, as in the instant case, accumulated depreciation will be reduced by an amount greater than the recorded amount. This treatment, long recognized by NARUC, allows for eventual full recovery of all investment necessary to serve customers. Whether the retirement cost estimate turns out to be over-stated or under-stated, is not relevant to whether the Company will have the opportunity to recover the full cost of its investment. This is because the cost estimate is taken out of both the plant balance and the accumulated depreciation balance. As soon as the accumulated depreciation equals the original cost, depreciation ceases. However, preventing a utility from recording retirements in accordance with NARUC and artificially limiting the amount of accumulated depreciation that can be recorded will result in a utility not receiving full recovery.**

6. Company Statement: "Further, it is inconsistent with NARUC accounting standards (Accounting Instruction No. 27 B (2))." The Company is commenting on Staff's recommendation concerning estimates for pump retirements as stated in footnote 1.

Staff Response: Staff does not agree that Staff's treatment is inconsistent with the NARUC accounting standards (Accounting Instruction No. 27 B (2)). Accounting Instruction No. 27 B (2) refers to paragraph D which states in part:

The book cost of the utility plant retired shall be the amount at which such property is included in the utility plant accounts, including all components of construction costs. The book cost shall be determined from the utility's records and if this cannot be done the cost shall be estimated.

Staff's treatment does not prohibit the Company from using an estimate. Staff's treatment concerns the amount of the estimate to be used and not the use of the estimate itself. To Staff's knowledge, there are no NARUC guidelines governing the calculation of the estimated cost of a retirement. Nevertheless, Staff revises its

recommendation to state that it is putting the Company on notice that, if the estimated cost of a retirement exceeds the accumulated depreciation balance, Staff may reduce the estimate so that it does not exceed the balance of the accumulated depreciation for that plant account.

**Company Response:**

**As Staff admits, NARUC allows the use of estimates. Further, the Company's estimate for the cost of the 2010 retirement is based upon the well established practice of reverse trending the current cost using the Handy-Whitman Cost Indices. Staff has accepted retirement cost estimates in the past based upon this practice.**

**Staff's revised recommendation is not effectively different than Staff's original recommendation as Staff can, at its discretion reduce the cost estimate if the estimate exceeds the balance of accumulated depreciation. Putting aside the fact Staff suggested practice would violate the NARUC account standards, as discussed previously, Staff recommendation would deny the Company an opportunity for full recovery of its investment. The corrective action to help prevent accumulated depreciation from going negative, as suggested in the Company's exceptions, is to set the depreciation rate to a rate that is more reflective of the actual life of the pumping equipment.**

**ACCUMULATED AMORTIZATION OF CONTRIBUTIONS-IN-AID OF CONSTRUCTION ("CIAC")**

7. Company Statement: "Staff's amortization rate employed for 2009 and 2010 of 7.25% is too high and should be reflective of the plant at issue."

Staff Response: Based upon review of the new documentation provided by the Company, Staff's CIAC amortization rate has been revised to 2.834 percent, which is the same as the rate proposed by the Company on page 19b of the application. Staff notes that at least one of the main extension agreements provided by the Company (i.e., Ranch Mesa Verde 2) explicitly indicated that services, meters, and hydrants were to be installed.

**Company Response:**

**The Company agrees the Staff revision.**



## REPAIRS AND MAINTENANCE EXPENSE

8. Company Statement: "On Staff Schedule CSB-3, page 2 of 8, Staff used \$8,671.35 as the Company's proposed reduction to repairs and maintenance expense. However, the Company proposed amount is \$7,759, not \$8,671.35. This adjustment was for the capitalized repairs and Well #2 of \$7,566 and for the removal of maintenance costs for the Somerton house of \$193."

Staff Response:

Staff agrees that the \$8,671.35 was for the capitalized repairs and Well #2 and for the removal of maintenance costs for the Somerton house. Staff has relabeled the line item as shown on Schedule CSB-3, page 2 of 8.

**Company Response:**

**The Company agrees the Staff revision as set forth in Staff Schedule CSB-2, page 2 of 8.**

## RATE CASE EXPENSE

9. Company Statement: "Staff is arguing that a small water company should receive no more than \$4,000 to promulgate a rate case."

Staff Response: Staff is not arguing that a small water company should receive no more than \$4,000. Rate case expense should be based on actual and reasonable costs. Staff's recommendation of \$4,000 in total rate case expense is reasonable for the instant case.

**Company Response:**

**The Company agrees that the rate case expense should be based upon "actual and reasonable" costs. There is no question that the Company's rate case expense is both "actual and reasonable." The Company has spent over \$6,500 to date with the cost of responses to the Staff responses, responses to the Recommended Order and Opinion and attendance at the Open Meeting yet to be incurred. The Company's rate case expense will far exceed its original estimate of \$7,500.**

**But while Staff states that the standard should be actual and reasonable, it is relying on its own analysis of selected cases to estimate what the expense should be. But this is neither actual nor reasonable; it is an estimate based upon other cases.**

That said, Staff states that its revised average rate case expense based on its analysis (see Item 11 below) is \$1,736. Staff is recommending annual rate case expense of \$1,333. The Company is seeking annual rate case expense of \$1,875. The Company's request is closer to Staff's revised average.

10. Company Statement: "[T]he analysis contains at least one error."

Staff Response:

Staff agrees that Orange Grove was authorized an annual rate case expense of \$3,375 amortized over 4 years for a total of \$13,500. Staff has revised its analysis to include the amount.

Company Response:

Upon further investigation, the Company has found at least one prior rate case that was omitted from Staff's analysis. Specifically, Staff has excluded the rate case for Livco Water Company (Docket No. W-02121A-07-0506) in which the Company was authorized rate case expense of \$13,500 "normalized" over 4 years or \$3,375 annually. In this rate case is included Staff's average rises to at least \$1,860. When only rate cases in which normalized rate case expense was requested are included, the average rises to \$2,437. The Company's request of \$1,875 is at the lower end of the range of \$1,860 to \$2,437.

Total Rate Case Expense	No. Years Amortized	Updated Staff	Annual Expense Case in which normalized RC expense was requested	Company	Docket No.
\$ -				Appaloosa Water	W-03443A-08-0313
\$ -				Fisher's Landing	WS-04047A-07-0708
\$ -				Groom Creek Water	W-01865A-07-0385 & 07-0384
\$ 13,500	4	\$ 3,375	\$ 3,375	Orange Grove 2007	W-02237A-08-0455
\$ -				Walnut Creek Water	W-02466A-08-0486
\$ 13,500	4	\$ 3,375	\$ 3,375	Livco Water	W-02121A-07-0506
\$ -				Northern Scottsdale	W-03270A-08-0225
\$ -				Ds Water	W-04049A-08-0339
\$ -				Lagoon Estates	W-01825A-09-0345
\$ -				Q Mtn Mobile Home	W-02518A-10-0227
Not Specified	Not Specified	\$ 54		Bellemont Water	W-02526A-09-0421
Not Specified	Not Specified	\$ 288		Granite Mountain	W-02467A-09-0333

Not Specified	Not Specified	\$ 600		Christopher Creek	W-20459A-08-0168
Not Specified	Not Specified	\$ 500		Ehrenberg Improvement	W-02273A-08-0251
\$ 3,000	5	\$ 600	\$ 600	Sonoita Water	W-20435A-09-0296 & 09-0298
Not Specified	Not Specified	\$ 1,000		Baca Float Water	WS-01678A-09-0376
Not Specified	Not Specified	\$ 1,545		Montezuma Rimrock	W-04254A-08-0361
\$ 7,500	4	\$ 1,875	\$ 1,875	Virgin Mountain	W-03551 A-09-0205
\$ 6,000	3	\$ 2,000	\$ 2,000	Mountain Glenn	W-03875A-08-0421
\$ 7,500	3	\$ 2,500	\$ 2,500	Little Park Water	W-02192-09-0531
\$ 10,000	3	\$ 3,333	\$ 3,333	Whitehorse Ranch	W-0416A-09-0471
Not Specified	Not Specified	\$ 5,000		Beaver Dam Water	W-03067A-08-0266
Average	3.6	\$ 1,860	\$ 2,437		
Median	3.7	\$ 1,710	\$ 2,500		

11. Company Statement: "[T]he rate cases for which no rate case expense was requested should be eliminated from the analysis."

Staff Response: The short form rate case application, which is used by Class D and E water companies, was designed to significantly reduce or eliminate rate case expense. The Commission purposefully built rate case cost reductions into the short form rate application, allowing the Company to complete the application with little or no help done to the simplified filing requirements and the "fill-in-the-blank" type format. Further, these applications are processed without a hearing, generally eliminating the need for a lawyer. Thus, it is reasonable to include in the analysis those companies that chose to take advantage of the built-in cost efficiencies afforded by the short-form rate application.

Also, Staff used its analysis of rate case expense for Class D water companies to determine whether Staff's recommended \$4,000 in total rate case expense was within a reasonable range. When Staff removed the companies for which there was no rate case expense, the average annual rate case expense was \$1,736. Staff's recommended annual rate case expense of \$1,333 is still within a reasonable range.

#### **Company Response:**

**Staff's position is a clear attempt to limit the ability of small water and sewer companies to employ competent professionals to assist in rate cases. Small companies prudently do not higher in-house accountants, attorneys, and**

engineers. Instead, such professionals are hired on an as needed basis – i.e., when the company is seeking a rate adjustment.

Staff's argument that the Company does not need professionals is disingenuous. The Company has hired one rate consultant and one attorney. Based upon the suggested expense recovery, Staff's position is essentially that the Company's rate consultant should be able to compile all the necessary documents, complete the rate and finance applications, answer all of Staff's questions, respond to all data requests, review and respond to the Staff report, and appear at any hearings in a length of time amounting to two working days (16-20 hours). Moreover, Staff believes small water companies should not be entitled to receive legal representation.

Yet, Staff has not one, but three employees assigned to the case. Even though they argue the Company should not be entitled to legal representation, Staff has at least one attorney working on this case. Knowing that Staff has three employees and an attorney working on this case, their argument that the Company can do without an attorney and limit the rate consultants to a couple days work should not be taken seriously.

Utilities which do not seek the assistance of qualified experts and legal counsel leaves the utility virtually defenseless against Staff. In some cases Staff makes mistakes or otherwise makes inappropriate recommendations. Without outside assistance from those with the knowledge and experience in rate making, utilities have no way of defending themselves against these errors and/or defending themselves against inappropriate rate making.

Finally, the rate application is not merely a fill in the blank form. In the instant case, the so-called "short-form" was 208 pages in length (not including an additional 128 pages submitted in support of operating expenses). For example, the determination of proposed rates and charges requires specialized knowledge and expertise to insure that the proposed rates generate the requested revenue requirement and the rate design balances the promotion of conservation with the need for revenue stability. Additionally, the application does require accounting knowledge. The short-form application does not have basic provisions or guidelines for adjusting the test year. Many applicants do not know that known and measurable changes are allowed or even that the cost of the rate case can be requested. Further, there are no provisions or guidelines in the short-form to help utilities determine the appropriate level of proposed revenues. Ignoring, or otherwise not making, appropriate known and measurable adjustments to the test year and/or not correctly determining the appropriate level of proposed revenues

**can result in the utility understating its revenues and/or expenses, leaving the utility to potential under earning, and in the extreme, financial distress.**

#### DEPRECIATION EXPENSE

12. Company Statement: "The Company disagrees with Staffs proposed level of depreciation expense."

Staff Response: Based upon review of the new documentation provided by the Company, Staff's CIAC amortization rate has been revised to 2.834 percent which is the same as the rate proposed by the Company on page 19b of the application. Staff notes that at least one of the main extension agreements provided by the Company (i.e., Ranch Mesa Verde 2) explicitly indicated that services, meters, and hydrants were to be installed. Staff has revised its depreciation expense based on the new CIAC amortization rate.

**Company Response:**

**With the exception of the depreciation rate employed for pumping equipment, as discussed above, the Company is in agreement with Staff on the change to the amortization rate and the computation of depreciation expense.**

#### WIFA DEBT SURCHARGE

13. Company Statement: "Debt surcharges that have been approved by the Commission in the past have included a gross up for income taxes on the principle portion of the loan payment."

Staff Response:

Staff has revised its surcharge mechanism to include income taxes.

**Company Response:**

**The Company is in agreement with Staff on the inclusion of income taxes in the computation of the debt surcharge.**

## OPERATING MARGIN

14. Company Statement: "The Company objects to Staff's 8.25% before debt surcharge, which should not factor into the equation because it is a direct pass through. The minimum operating margin should be 10%."

Staff Response: Staff utilized a cash flow methodology to set the Company's revenue requirement. The operating margin was merely a fall-out of Staff's cash flow analysis.

### **Company Response:**

Staff cash flow analysis as shown on Schedule CSB-7 contains at least one error. Specifically, Line 31 only shows the principal portion of the loan payment or \$872. Line 31 should reflect the principal and interest payment totaling \$2,426. This error results in an overstatement of the cash flow shown on Line 32. The correct amount for Line 32 should be \$13,472.

In order to achieve the \$15,072 cash flow Staff asserts is the basis for their "fall-out" operating margin, the operating income needs to be \$13,739 (\$12,185 as shown in Column C, line 23 plus \$1,554 of annual interest expense). Staff's "fall-out" operating margin needs to be at least 11.4%.

## RATE DESIGN

15. Company Statement: "In the last rate case (Decision 71110), the Commission authorized revenues of over \$120,000. After a full year of new rates, the Company generated less than \$109,000. So, clearly the rate design has impacted the Company's revenues to a fairly significant extent."

Staff Response: Staff believes that there are factors at play other than rate design. Such factors may include number of customers and the downturn in the economy.

### **Company Response:**

Staff's speculation regarding how their proposed rate design will impact revenues (and revenue stability) improperly places the risk on the Company. Staff should not change the current rate design by shifting revenue recovery away from the monthly minimums and to the commodity rates. The best course of action under the circumstances should be to evenly distribute the revenue increase to the monthly minimums and to the commodity rates as the Company has proposed.

**Knowing the Company did not generate the authorized revenue requirement from the last rate case, it is clear that the inverted tier rate design contributed to the decline in revenues. Average monthly usage for a 5/8 x 3/4 inch customer decreased from over 8,800 to less than 7,800 gallons. Also known is that the economy has been poor over the last several years and continues to falter. The economy may not recover for many more years. However, whether it is the combination of the rate design and the economy which lead to reduced revenues, Staff should not be changing the current rate design unless Staff can show that revenue instability will not be increased and revenues will not continue to erode as a result of their rate design. Orange Grove is a very small utility and relatively small changes to its revenues and expenses can dramatically change its financial condition. Orange Grove should not be subject to unsupported changes to its current rate design.**

#### MISCELLANEOUS SERVICE CHARGES

16. Company Statement: "The Company has found that many customers fail to pay their bills on time and when the late charge is very small, customers have no incentive to pay on time and will delay payment as long as possible. The delays in payment can have a severe impact on the cash flows of the Company."

Staff Response: The 1.5 percent late charge is appropriate. The Company has not provided any documentation for the Commission to deviate from its typical late charge.

**Company Response:**

**The Company will accept Staff's recommendation.**